DEPARTMENT OF STATE REVENUE
LETTER OF FINDINGS NUMBER: 04-0427
Corporate Income Tax
For the Years 2000 and 2001

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ISSUE

I. Gross Income Tax—Indiana sales

Authority: IC 6-8.1-5-1(b); IC 6-2.1-2-2(a)(2); IC 6-7-1 *et seq.*; 45 IAC 1.1-3-3(c); Indiana Dep't of State Revenue v. Bethlehem Steel Corp., 639 N.E.2d 264 (Ind. 1994).

Taxpayer protests the imposition of Gross Income Tax, arguing it did not solicit sales from within Indiana.

II. Adjusted Gross Income Tax—Royalty payments

Authority: IC 6-3-2-2(*l*) and (m); Gregory v. Helvering, 293 U.S. 465 (1935); Commissioner v. Transp. Trading and Terminal Corp., 176 F.2d 570 (2nd Cir. 1949); Horn v. Commissioner, 968 F.2d 1229 (D.C. Cir. 1992); Lee v. Commissioner, 155 F.2d 584 (2d Cir. 1998).

Taxpayer protests the Department requiring the filing of a unitary return of Taxpayer and an affiliated royalty company.

III. Penalty

Authority: IC 6-8.1-10-2.1; 45 IAC 15-11-2(b) and (c).

Taxpayer requests an abatement of penalties

STATEMENT OF FACTS

Taxpayer, a manufacturer of cigarettes, is domiciled in North Carolina. Taxpayer is a multistate corporation with sales to Indiana. All products sold in Indiana are shipped from warehouses located outside Indiana. Taxpayer's only sales into Indiana are sales to direct account distributors. The distributors are wholesalers licensed by the State of Indiana to place a cigarette tax stamp on the cigarette pack. Because the cigarette tax stamp has to be placed on the packs, cigarettes coming into Indiana may be sold only to authorized distributors. These direct account wholesalers then resell the cigarettes to Indiana retailers.

Taxpayer paid royalties of 4.5% of its Indiana revenue sales to Royalty, a subsidiary domiciled in North Carolina. Taxpayer deducted the royalty payments as an expense on its Indiana return. Royalty is domiciled in North Carolina.

Taxpayer filed amended income tax returns for 1997, 1998, and 1999. The Department denied the refunds claimed by Taxpayer and conducted an audit for 2000 and 2001. Taxpayer was issued an assessment, which included imposition of gross income tax and adjusted gross income tax. The assessment of adjusted gross income tax was caused by the Department's requiring a unitary return to be filed by both Taxpayer and Royalty to fairly reflect the Indiana source income.

Taxpayer protested the denial of refund and the imposition of an assessment. A hearing was held. The determination of the assessment issues is binding upon the refund claims.

I. Gross Income Tax—Indiana sales

DISCUSSION

All tax assessments are presumed to be accurate; the taxpayer bears the burden of proving that an assessment is incorrect. IC 6-8.1-5-1(b).

Under IC 6-2.1-2-2(a)(2), a nonresident taxpayer was subject to gross income tax only on the taxable gross income derived from activities, businesses, or any other sources within Indiana. Indiana Courts have held that gross income tax may not be imposed upon receipts received by a taxpayer from the sale of tangible personal property if the activities giving rise to the receipts are interstate in character and the in-state activities are *de minimus*. *See*, Indiana Dep't of State Revenue v. Bethlehem Steel Corp., 639 N.E.2d 264 (Ind. 1994). Where the Indiana activities are merely incidental to a corporation's total operation, they are insufficient for the Indiana Department of State Revenue to seize upon in attempting to apply IC 6-2.1-2-2(a)(2). *Id.* at 271.

45 IAC 1.1-3-3(c) states that gross income derived from the sale of tangible personal property in interstate commerce is not subject to the gross income tax if the sale is not completed in Indiana. 45 IAC 1.1-3-3(c)(5) states that a sale to an Indiana buyer by a nonresident with an in-state business situs or activities but the situs or activities are not significantly associated with the sale because it was initiated, negotiated, and serviced by out-of-state personnel and the goods are shipped from out of state is not Indiana source income. However, Taxpayer had in-state personnel who initiated, negotiated, and serviced the retail stores in conjunction with the sales to the distributors.

For the years in question, Taxpayer had at least fifty customer service representatives (CSR) whose responsibilities included visiting retail locations to promote the products and maintain quality standards. The duties of the CSRs included monitoring contracts for product placements within the retail stores; handling outdated and damaged products; assembling and placing promotions and displays; monitoring competitor activity; and completing requests for information, such as surveys. Taxpayer states that the CSRs did not solicit sales, but the

representatives were servicing the retail stores. According to the audit report, the CSRs negotiated and contracted for desirable product placement within the retail locations. The CSRs also evaluated the store's inventory and authorized returns of product to the distributor for credit or replacement. While the retail stores were required under IC 6-7-1 *et seq.* to purchase the cigarettes from a distributor, it was Taxpayer who monitored and serviced the retail locations to encourage and promote sales. Without a demand for product, the orders would not be placed by the retail store to the distributor. It is significant to note that Taxpayer authorized the return of damaged and outdated product to the distributor.

Taxpayer seeks to isolate the sale of product to the distributor alone. And while the orders were sent to out-of-state locations and were shipped from out-of-state warehouses, Taxpayer was actively working with both the distributor and the retailers to solicit, promote, and service the Indiana sales. When taken as a whole, the activities of Taxpayer's in-state employees show that the sales were made within Indiana.

FINDING

For the reasons stated above, Taxpayer's protest is denied.

II. Adjusted Gross Income Tax—Royalty payments

DISCUSSION

Taxpayer reported large deductions on its federal return for royalty payments to an affiliated company, Royalty. Royalty is a wholly-owned subsidiary of Taxpayer and its sole business is the ownership and administration of trade names, trademarks, service marks, and related trade marks formally owned by Taxpayer in its cigarette business. The auditor for the Department stated in the audit report that the use of the intellectual property by Taxpayer is integral to its operations. For this reason, the activities of Royalty is unitary with Taxpayer.

IC 6-3-2-2(*l*) states:

> If the allocation and apportionment provisions of this article do not fairly represent the taxpayer's income derived from sources within the state of Indiana, the taxpayer may petition for or the department may require, in respect to all or any part of the taxpayer's business activity, if reasonable:
> (1) separate accounting;
> (2) the exclusion of any one (1) or more of the factors;
> (3) the inclusion of one (1) or more additional factors which will fairly represent the taxpayer's income derived from sources within the state of Indiana; or
> (4) the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income.

In addition, IC 6-3-2-2(m) states:

> In the case of two or more organizations, trades, or businesses owned or controlled directly or indirectly by the same interests, the Department shall distribute, apportion, or allocate the income derived from sources within the state of Indiana between and among those organizations, trades

> or businesses in order to fairly reflect and report the income derived from sources within the state of Indiana by various taxpayers.

Because Royalty is a wholly owned subsidiary of Taxpayer, common control is not at issue.

The issue remains as to whether Taxpayer and Royalty in fact constituted a unitary business. It needs to be stated that Taxpayer framed its protest as a disallowed deduction of royalties paid by Taxpayer to Royalty. While the functional effect may be a disallowance of the deduction, the audit technically did not disallow the deduction, but instead had Taxpayer and Royalty file a unitary return.

Under the agreement between Taxpayer and Royalty, Taxpayer paid Royalty a royalty of 4.5% of Taxpayer's sales. Taxpayer sold cigarettes in Indiana. The value of the trade names, trademarks, and other intellectual properties is inextricably connected with the quality of the cigarette products manufactured by Taxpayer. The effect of the royalty payments was to shift 4.5% of the sales income from Taxpayer to Royalty. The filing of a unitary return better reflects the intercompany transaction.

The "sham transaction" doctrine is well established both in state and federal tax jurisprudence dating back to Gregory v. Helvering, 293 U.S. 465 (1935). The United States Supreme Court held in the case that in order to qualify for a favorable tax treatment, a corporate reorganization must be motivated by the furtherance of a legitimate corporate business purpose. *Id.* at 469. A corporate business activity undertaken merely for the purpose of avoiding taxes was without substance; "To hold otherwise would be to exalt artifice above reality and to deprive the statutory provision in question of all serious purpose." *Id.* at 470. Courts subsequently have held that in construing words of a tax statute which describe any commercial transactions, the court is to understand them to refer to transactions entered upon for commercial or industrial purposes and not to include transactions entered upon for no other motive but to escape taxation." Commissioner v. Transp. Trading and Terminal Corp., 176 F.2d 570, 572 (2nd Cir. 1949), *cert denied*, 338 U.S. 955 (1950). Transactions that are invalidated by the sham transaction doctrine are those motivated by nothing other than the taxpayer's desire to secure the attached tax benefit but are devoid of any economic substance. Horn v. Commissioner, 968 F.2d 1229, 1236-37 (D.C. Cir. 1992). The question of whether or not a transaction is a sham, for purposes of the doctrine, is primarily a factual one. Lee v. Commissioner, 155 F.2d 584, 586 (2d Cir. 1998). The taxpayer has the burden of demonstrating that the subject transaction was entered into for a legitimate business purpose. IC 6-8.1-5-1(b).

Taxpayer stated at the hearing that the purpose of establishing Royalty was to be able to exploit the intellectual properties. However, in light of the fact that the value of the intellectual properties is based on the quality of the products sold by Taxpayer, the royalty payments have the effect of shifting income from Taxpayer to Royalty. While this had no effect on the federal tax returns, it does effect Taxpayer's Indiana return because Taxpayer has claimed a deduction for a transaction that shifted 4.5% of Taxpayer's revenues generated within the State of Indiana to an out-of-state affiliated entity. The value of the intellectual properties held by Royalty and the revenues received by Royalty were generated by the sale of Taxpayer's product within Indiana. This explains why a unitary return is appropriate to fairly reflect the transactions.

Further, even if a unitary return is not permissible for whatever reason, the transaction is still a sham, and thus the deduction for expenses from Taxpayer to Royalty should be disallowed.

FINDING

For the reasons stated above, Taxpayer's protest is denied.

III. Penalty

DISCUSSION

Taxpayer asks the Department to abate the 10% negligence penalties because the position of Taxpayer and its Parent for the audit years in question were based upon reasonable and proper interpretation of both state and federal law.

IC 6-8.1-10-2.1 requires that a 10 % penalty be imposed if the tax deficiency results from the taxpayer's negligence. 45 IAC 15-11-2(b) defines negligence as "the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer." Negligence is to "be determined on a case-by-case basis according to the facts and circumstances of each taxpayer." *Id.*

IC 6-8.1-10-2.1(d) allows the Department to waive the penalty upon a showing that the failure to pay the deficiency was based on "reasonable cause and not due to willful neglect." 45 IAC 15-11-2(c) requires that in order to establish "reasonable cause," the taxpayer must demonstrate that it "exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed . . . ."

Taxpayer has not shown it used the "ordinary business care and prudence" expected of an "ordinary reasonable taxpayer" that would warrant abatement of the negligence penalty.

FINDING

For the reasons stated above, Taxpayer's protest is denied.

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